Central Intelligence Agency

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France: Austerity and Improved Foreign Payments

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Summary

The Mitterrand government appears committed to fiscal and monetary austerity in an attempt to improve the balance of payments and promote structural adjustment in the economy. Although he immediately implemented expansionary policies after taking office in 1981, Mitterrand soon realized such policies were unsustainable. Increasing economic growth caused a rapid escalation in imports while the economic recession in most of France's major trading partners led to a fall in exports. As a result, the current account plunged to a $12 billion deficit in 1982 and gross medium-and long-term debt rose to about $45 billion. Socialist economic policy began to be readjusted in mid-1982 and over the course of the next nine months it became decidedly restrictive.

- o Credit controls were tightened.

- o A 3-percent cap on the ratio of the general government budget deficit to GDP was established.

- o Initial steps to deindex wages were taken. 25X1

Mitterrand tightened economic policies further in the spring of 1983 by raising taxes, cutting government spending, and

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reducing monetary growth targets. The government's policy stance remained restrictive in 1984. 25X1

The reversal in economic policy, coupled with improving economic conditions in the rest of the world and the appreciation of the dollar, clearly has helped France's international payments position. Economic growth has slowed relative to key trading partners and trade competitiveness has improved dramatically, causing the current account deficit to be almost eliminated in 1984. 25X1

French economic policy will continue to be influenced over the next several years by Mitterrand's desire to run a current account surplus and to reduce foreign debt. Although some commentators suggest that the Socialists will once again attempt to accelerate growth before the National Assembly elections in 1986, we believe that what room exists for easing economic policy will be saved for the runup to the 1988 presidential election rather than spent on the 1986 National Assembly elections. Initial small steps and a major announcement might be made just before the Assembly elections, however, in hopes of a benefit from the announcement but with implementation saved for late 1986 or 1987. The experience of the past four years has pursuaded the Socialists that France has little room for pursuing an expansionary macroeconomic policy and that pump priming is not a solution to its long-run structural problems. In addition, a new series of policy flip-flops would not produce the credentials for economic management that Mitterrand seeks to establish. 25X1

The relative cyclical position of the French economy and improving price competitiveness over the past several years lead us to expect continuing improvement in French foreign payments this year. Most other forecasters agree with this prognosis. To preserve the international competitiveness of French firms, however, Paris will have to accept future devaluations of the franc within the European Monetary System because French inflation continues to exceed that of many of its EC partners -- particularly West Germany, France's largest export market. Despite the brighter picture for France's international payments position, the improvement probably will not be rapid enough to reduce significantly French foreign debt, which currently stands at $55-60 billion. As a result, interest payment and debt amortization will continue to place some burden on the economy and reduce French options for the medium term. 25X1

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The strength of the world economy, the behavior of exchange rates, and the level of interest rates are all extremely important to the success of the Socialist austerity program. Therefore, the French will scrutinize developments in these areas and will criticize any US policy moves they perceive as a threat. The US budget deficit and its impact on interest rates will continue to be a prime target for French criticism. The French also will continue to press for reforms of the international monetary system that would stabilize exchange rates, reduce the influence of the dollar, and force "discipline" on the United States as well as smaller countries. 25X1

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TABLE OF CONTENTS

25X1

Introduction

Following their presidential and parliamentary election victories in 1981, the French Socialists adopted expansionary economic policies with little heed for their balance-of-payments impact. These policies, pursued at a time when the economies of France's major trading partners were stagnating, led to a rapid deterioration in the French current account in 1982 and to a series of franc devaluations within the European Monetary System (EMS). Convinced finally of the need to change direction, the government in June 1982 began to institute progressively sterner austerity measures which, when combined with the effects of the US economic recovery, produced an improved balance-of-payments situation and a relatively stable franc in 1983. 25X1

This paper assesses the Mitterrand government's changed approach to balance-of-payments issues and examines the prospects for improvement over the next few years. It also examines how balance-of-payments constraints have affected Socialist views regarding international trade and monetary reform. 25X1

Background: The Barre Years

From late 1976 until the Socialist victory in 1981, President Giscard d'Estaing and Prime Minister Barre tried to keep a leash on the economy, following the expansionary thrust of September 1975 that had quickly led to accelerating wages and prices and a rapid deterioration in the current account. "Barrism" -- aimed at reducing inflation, stablizing the franc, and improving the current account balance -- involved tighter fiscal and monetary policy as well as outright price and wage controls. 25X1

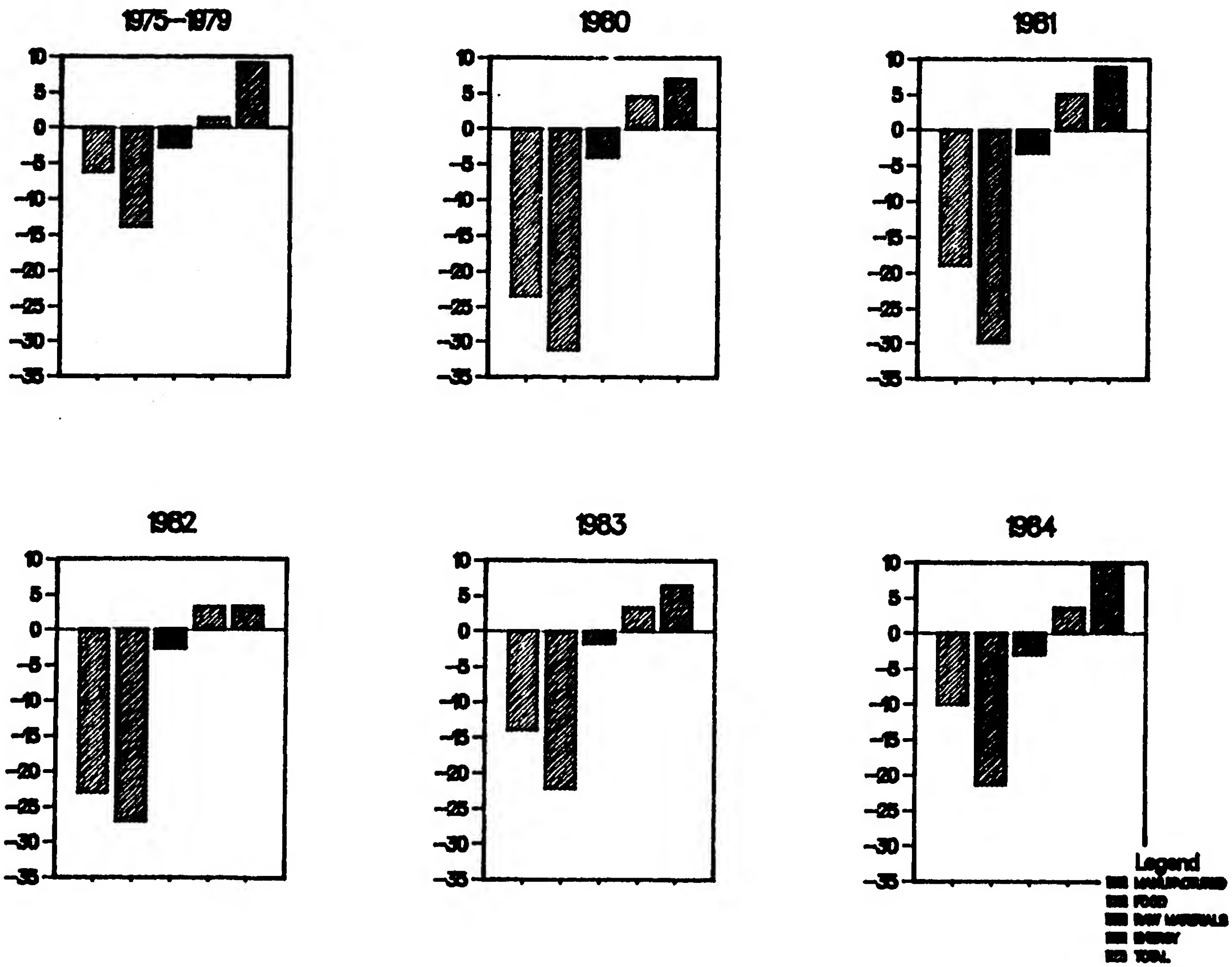
Barre's policies were generally successful. For the years 1975 to 1979 the surplus on current account averaged over $2 billion, with a growing services surplus offsetting deficits on goods trade and transfers. But economic growth during the same period, while higher than the European Community (EC) average and about the same as the OECD average, was lower than the rate the French had come to expect. Unemployment also increased significantly for both cyclical and structural reasons. 25X1

The 1979 oil shock and subsequent worldwide recession caused a rapid deterioration in the trade balance and pushed France's current account into a $4 billion deficit (see Table 1 and Charts 1a and b). The economic slowdown in France itself boosted unemployment from 6 percent in 1979 to 8.5 percent by the 1981 elections. After five years of slow growth and still smarting from the effects of the second oil shock, the French had had enough "Barrism" and elected Mitterrand President. 25X1

Mitterrand's Expansionist Period

Responding to his perceived electoral mandate for change, President

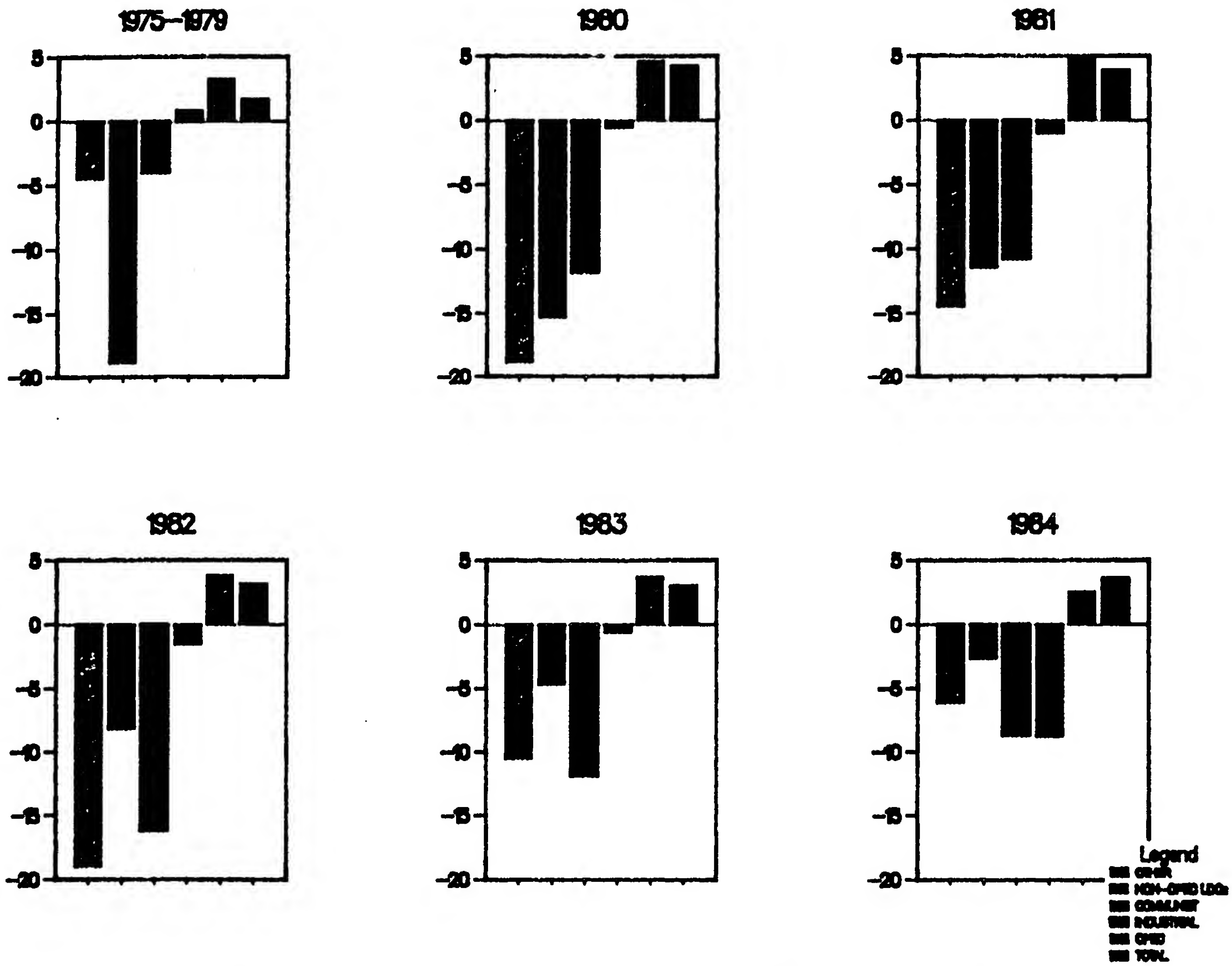
Chart 1 A. Trade Balance by Commodity ($Billion, FOB—CIF Excluding Military)



The French trade deficit is largely due to a structural imbalance in energy trade and to a smaller raw materials deficit. These deficits are sensitive to variations in the price of oil and, from the French view, to variations in the value of the dollar.

The French depend on a surplus in manufactured goods trade to defray the cost of imported energy and raw materials. The deterioration in the trade balance in 1982 and the reversal in 1983 were largely due to cyclical variations in manufactured goods trade.

Chart 1 B. Trade Balance by Economic Group ($Billion, FOB–CIF)



The French trade deficit with OPEC has improved significantly since the second oil shock.

French trade with other industrial countries is structurally in deficit. France has a bilateral deficit with most individual industrial countries, the largest being with West Germany, the US, the Netherlands, Japan, and Italy in 1983.

France's only consistent surplus is with the non–oil LDCs, which is a factor explaining French concerns with their economies.

Other trade is largely military trade for which an area breakdown is unavailable.

Mitterrand reoriented economic policy toward strong growth, improved employment, and income redistribution. He stimulated economic growth through large increases in government spending, public employment, and welfare transfers to the disadvantaged (see Text Box). The Socialists hoped that stimulating income growth, especially among the poor, would increase demand for domestic rather than imported goods -- a hope that flew in the face of France's historical experience; typically, imports respond rapidly and more than proportionally to expanding income. The French government also mistakenly foresaw a world recovery in 1982 that would increase the demand for French goods and tend to offset any rise in imports. The combination of increased consumption and foreign demand also was expected to promote investment. The world growth scenario forecast by the Socialists did not seem unreasonable -- the OECD published a similar view at the time. 25X1

French economic growth, which had been negative in the four quarters preceding the Socialist victory, rose to nearly 2.5 percent in the year following the election. Consumption grew by over 4 percent in the same period. As might be expected from a sudden increase in purchasing power, consumers spent a large part of their windfall on consumer durables such as automobiles and household appliances, whose import shares range from 30 to 50 percent compared to 25 percent or less for non-durable consumer goods. Imports increased far more rapidly than the government had projected. 25X1

Exports, on the other hand, were far below expectations. The world recession had seemed to be over when economic growth in the Big Seven topped 3.5 percent in the first half of 1981, but it deepened as output actually fell during 1982. Over the first 18 months of Mitterrand's administration, average annual economic growth in the other Big Seven countries was about 2 percentage points below that in France. At the same time, under the influence of falling oil demand and the emergence of alternative supplies, OPEC imports from all sources rose only 2 percent from mid-1981 until the end of 1982. 25X1 Non-oil LDC imports fell by 13 percent between the inauguration of Mitterrand and the end of 1982, due to the world debt crisis and the world recession.

The final blow to the French current account was the appreciating dollar. 25X1 Beginning in late 1980, the dollar strengthened almost without interruption through yearend 1982. Although the rising dollar ultimately improved the competitiveness of French goods, the shifts in export and import volume were not felt for some time. In the meantime, the immediate impact of exchange rate changes was to reduce the dollar value of French exports. Valued in francs, the trade deficit worsened appreciably due to the rapidly inflating cost of imports, particularly oil and other raw materials priced in dollars. 25X1

The combination of increasing import demand, deteriorating export markets, and the appreciation of the dollar produced a current account deficit of $12 billion in 1982. The growing deficit carried in its wake two franc

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Economic Policy: 1976-1984

<u>Barrism</u> - Fall 1976 - Spring 1981

-- Emphasis on reducing inflation, improving the balance of payments, and supporting the franc.

-- Gradual tightening of fiscal and monetary policy.

-- Imposition and then gradual liberalization of price controls.

<u>Socialism</u> - Summer 1981 - Present

<u>Expansion</u> - Summer 1981 - Summer 1982

-- Emphasis on boosting growth and employment.

-- Rapid fiscal expansion and growth of government employment.

-- Nationalization of large firms and banks.

-- Large increases in minimum wages, family assistance, aid to handicapped, housing aid, and pensions.

-- Renewal of some price controls.

<u>Rigor I</u> - Summer 1982 - Spring 1983

-- Franc devalued 6.75 percent relative to ECU.

-- Prices, wages, and dividends frozen for four months.

-- Prices and wages to be negotiated within 8-percent ceiling after freeze. First steps to deindexing wages.

-- 3-percent cap set on ratio of general government budget deficit to GDP.

-- Credit controls tightened.

<u>Rigor II</u> - Spring 1983

-- Franc devalued 2.5 percent relative to ECU.

-- Budget expenditures cut to respect 3-percent deficit target.

-- Taxes increased and fees imposed for hospital stays.

-- Forced loan to government equal to 10 percent of 1982 taxes in excess of $750.00

-- Foreign exchange controls imposed, particularly affecting French tourists abroad.

-- Monetary growth target reduced from 10 percent to 9 percent.

Rigor II Extended - 1984

-- Continuation of policy stance set in 1983.

-- Monetary growth target reduced to 6 percent.

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devaluations in the European Monetary system (EMS) by mid-1982, the prospect of frequent exchange market difficulties, and a ballooning foreign debt.

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Socialist Austerity

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By mid-1982, the Socialists realized that the growing deficit was unsustainable and that the world economy was not recovering as anticipated. Following the second franc devaluation in June, the Socialists moderated their expansionary policy. Initial austerity measures consisted mainly of temporary price and wage controls and actions to slow the growth of the government deficit. By the first quarter of 1983, the current account deficit soared to an annual rate of $18 billion, in part because of speculation by importers and exporters anticipating another EMS adjustment. In March the franc was devalued again by 2.5 percent and the mark revalued by 4.5 percent. 25X1

Despite agreement within the government that further steps were needed, there was considerable debate concerning what these steps should be. The vocal leftwing Socialist CERES faction, led by Jean-Pierre Chevenement, proposed abandoning the EMS and following protectionist policies. The more market-oriented philosophy of Finance Minister Delors prevailed, however, and President Mitterrand chose more economic austerity. Since then, tighter controls on government spending and additional taxes have nearly stabilized the ratio of the general government deficit to GDP. The rate of growth of the money supply (M2) has been reduced from over 12 percent in 1982 to an estimated 7 percent in 1984 (see Chart 2). In addition, the government toughened restrictions on tourist expenditures abroad and imposed a forced loan to the government by taxpayers. 25X1

The current account balance improved markedly in the second quarter of 1983, in part due to unwinding of earlier speculation by importers and exporters and in part due to the lagged trade response to previous exchange rate changes and policy decisions. As the world recovery strengthened through 1983 and French austerity began to bite, the deficit actually turned into a surplus by yearend -- although part of the improvement probably reflected cosmetic timing of oil imports by Paris. For 1983 as a whole the current account deficit was only $4 billion, roughly one-third the amount incurred in 1982. 25X1

Several factors underlay the rapid improvement in France's trade accounts:

-- French growth in 1983 slowed and remained positive only due to strong export demand.

-- Economic recovery in the other Big Seven countries closed the growth gap with France. By the end of 1983, relative French GDP was near where it had been in the first half of 1981 (see Chart 3).

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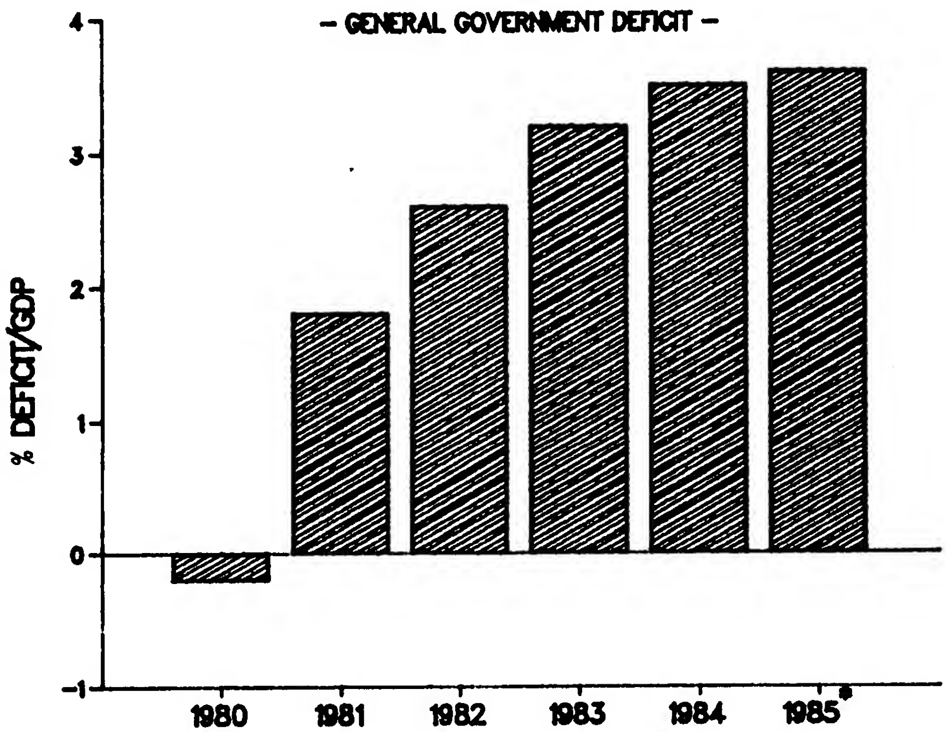
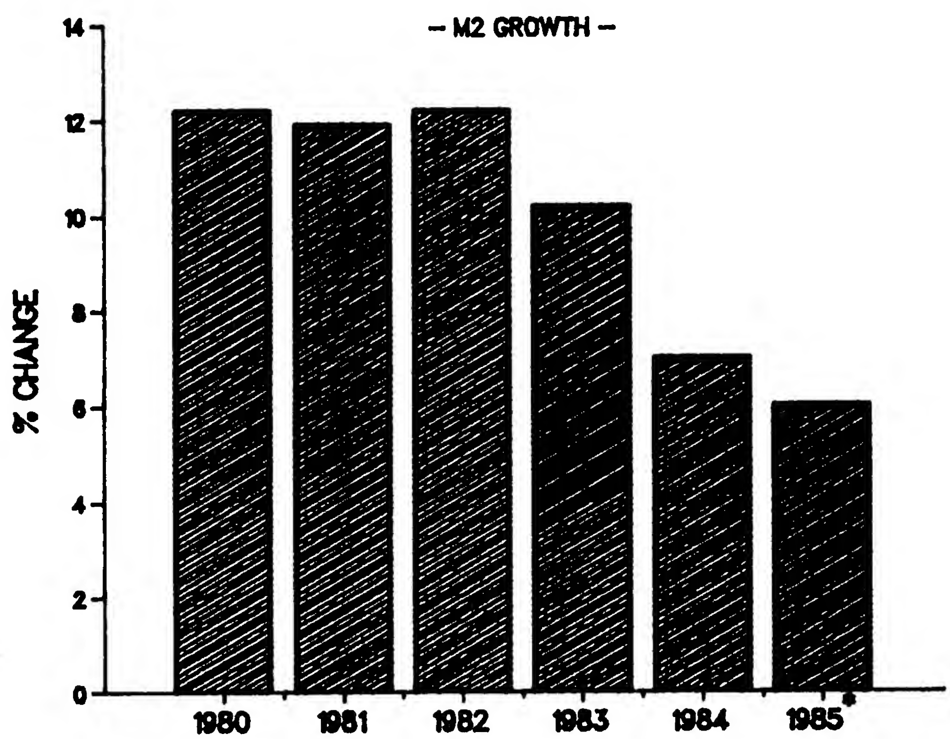
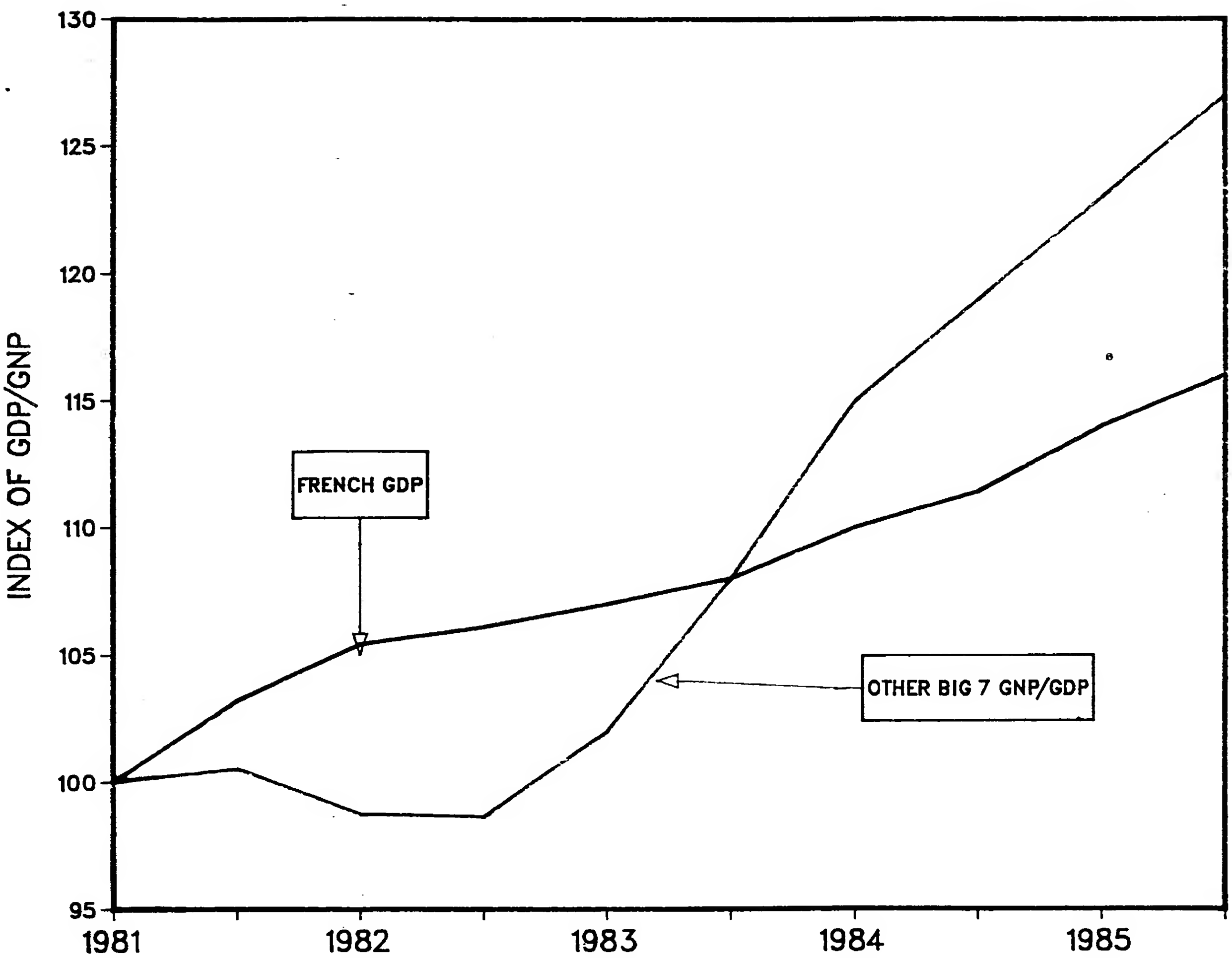
CHART 2. MONETARY AND FISCAL POLICY





*Year end to year end change

CHART 3. FRENCH AND BIG SEVEN GDP/GNP
1981:1=100



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-- The consumption binge ended. From the final quarter of 1982 to the same quarter a year later the volume of manufactured goods purchased fell 3.5 percent. The effect on imports of consumer durables was magnified -- just as it had been in the opposite direction during the expansion phase.

-- French price competitiveness continued to improve throughout 1983 as relative exchange rate movements, mainly the appreciation of the dollar, more than compensated for the difference between French inflation and foreign inflation (see Chart 4). 25X1

In contrast to the trade account, which deteriorated rapidly in 1982 and improved even more rapidly in 1983, the service surplus fell continuously from 1980 through 1983. The decline, from $9 billion in 1980 to $4 billion in 1983, was due largely to lower net receipts of "interest and dividends" which fell from a $2.3-billion surplus to a $1-billion deficit. This deterioration reflected:

-- The failure early in the period of long-term interest rates to keep up with short-term interest rates. Because French banks were generally borrowing short and lending long, revenues fell short of payments.

-- The late payment or non-payment of interest receipts from rescheduled or problem loans.

-- The decline in dividends and direct investment income because of the depressed world economy.

-- The reduced dollar value of income from loans denominated in francs due to the appreciation of the dollar.

-- Increased interest liabilities due to the rapid growth of France's net debt. 25X1

Other services categories remained fairly stable in this period. Technical services receipts, for example -- reflecting payments on longer term contracts such as engineering, public works, patents, and licensing -- held up well. The French, however, are concerned that this important surplus category will decline because of the dearth of contracts signed in 1983 and 1984, particularly with OPEC and non-OPEC LDCs. 25X1

In 1984 the French followed the same macroeconomic policy guidelines as in 1983, and most economic indicators continued to improve. French GDP growth increased, while remaining below the Big Seven average growth rate. At the same time, the inflation differential between France and its major trading partners fell from near 4.5 percent in 1983 to only 2.5 percent in 1984. Moreover, the trade deficit improved markedly -- shrinking by one-half to $4

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CHART 4. FRENCH PRICES AND COSTS RELATIVE TO OTHER INDUSTRIALIED COUNTRIES

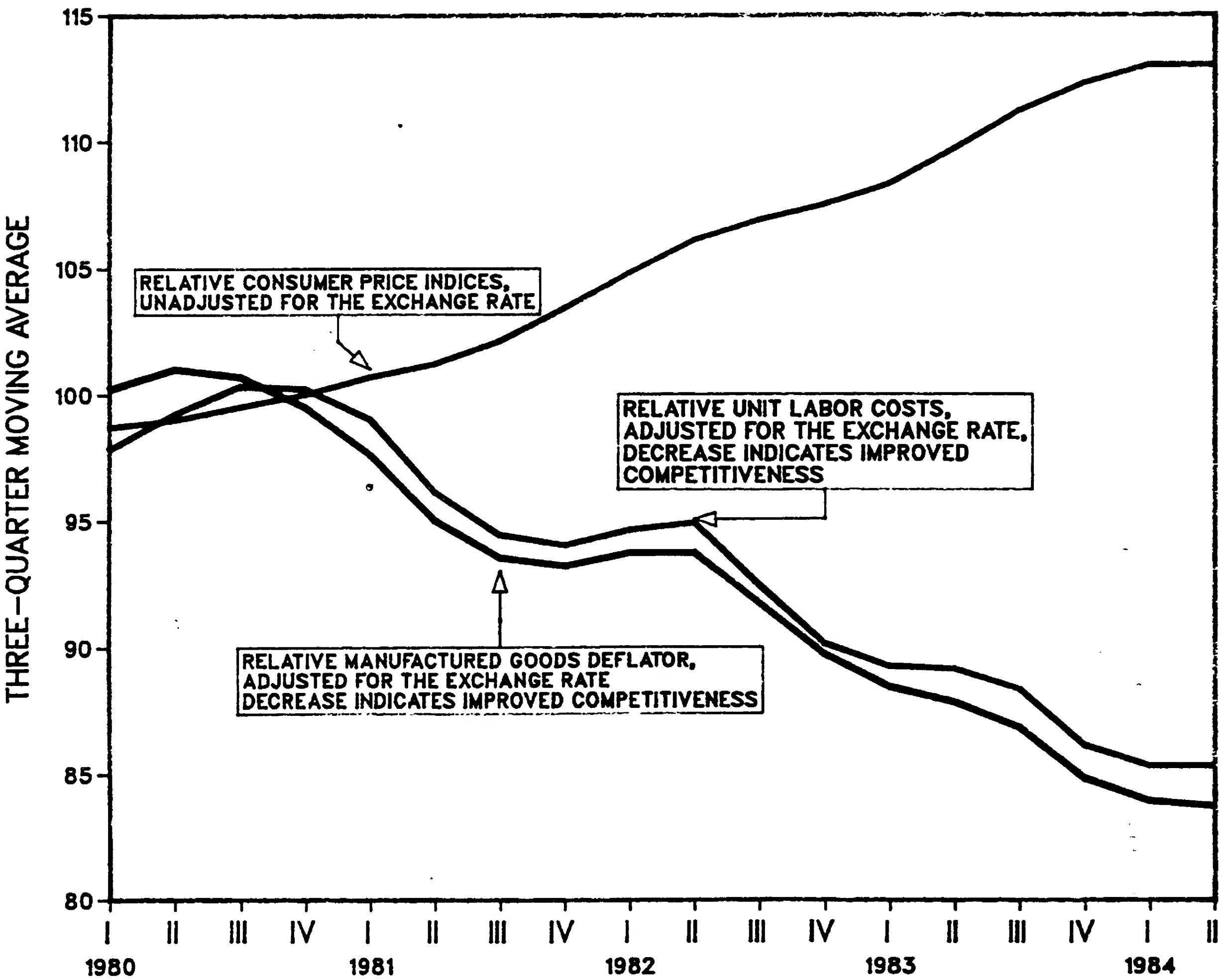

Table 2

Balance of Payments Forecasts: 1985
($ Million)

Organization	Dates	Trade	Current Account	GDP (% Change)
CIA	Current	-1.0	1.5	2.25
IMF	9/84	NA	0.2	1.7
OECD	12/84	-1.25	2.00	2.0
Embassy	8/84	-1.0	0.0	2.0
1985 French Budget	9/84	0.3	NA	2.0

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billion in 1984 -- while the current moved into balance, following a $4 billion deficit in 1983. 25X1

Outlook

The significant improvement in the French current account in 1983 and 1984 indicates that a large part of the adjustment necessary to restore health to France's foreign payments has already taken effect. The Socialists have made considerable progress in rectifying their early errors as well as in resolving some of the longer term problems of the French economy. Inflation has been cut from 14 percent in 1981 to about half that in 1984. The government also has made significant steps toward reducing aid to lame duck industries -- such as steel and shipbuilding. In the decade after the first oil shock, the French attempted to maintain both real wages of workers and the real purchasing power of consumers. This was done by preventing some prices from increasing enough to cover increased costs and by increasing the tax and social security burdens on firms. The Socialists have recognized the pitfalls of this policy and have taken steps -- such as weakening wage indexation, reducing payroll taxes, gradually returning to market determined prices, and trying to reduce interest rates -- to reverse the decade-long decline in the profitability of firms. 25X1

The relative cyclical position of the French economy and improving price competitiveness over the past several years lead us to expect continuing improvement in French foreign payments this year. Most other forecasters, including the IMF and the OECD, agree with this prognosis (see Table 2). Improvement in foreign payments over the next several years will probably not be rapid enough, however, to reduce French foreign debt significantly. As a result, interest payments and debt amortization will continue to place some burden on the economy and reduce French options for the medium term (see Text Box). 25X1

The improvement in the French current account over the past several years has been aided through depreciation of the franc relative to the currencies of its major trading partners, mainly the dollar. Although the inflation differential between France and its major trading partners has been reduced from over 6 percentage points in early 1982 to near 3 percentage points since mid-1984, further depreciation, particularly with respect to the mark, will be required to preserve the ability of French firms to compete internationally. We expect French wage costs will increase more than West German wage costs by an amount that is not warranted by productivity changes. 25X1

Internal Risks

Some commentators suggest that the Socialists will once again attempt to accelerate growth before the National Assembly elections in 1986, perhaps beginning in early to mid-1985. Although we cannot rule out such a development, we believe the probability is low for the following reasons:

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-- According to both press reports and reports from the Embassy in Paris, the experience of the past three years has convinced the Socialists that the long-run health of the economy requires the creation of new activities and less support for unprofitable use of their resources. French decisionmakers now see much of the unemployment problem as structural rather than cyclical. Such an evaluation does not recommend pump priming.

-- In both the 1975 expansion and the 1981 Socialist experiment, the French encountered serious economic problems fairly rapidly. Domestically induced growth in each instance led to a magnified surge in imports. Were the Socialists to increase domestic spending in 1985, they would risk large current account deficits, induce capital flight, and probably an additional devaluation before the 1986 elections. They also would risk renewing inflation and inflationary expectations. If the increased demand were perceived as temporary, to be replaced again by austerity after the elections, it would probably not generate many new jobs, given the legal difficulty French employers have in reducing their workforces in response to cyclical downturns. Thus, even viewed from the narrow viewpoint of the 1986 elections alone, stimulation could cause more short-term bad news than good news.

-- The political costs of pump priming probably would be fairly high as well. According to US Embassy and press reporting, one of Mitterrand's main objectives has been to establish Socialist credentials for managing the economy. A series of rapid policy reversals would tarnish what credibility the government has earned. Polls indicate that the populace views austerity as a necessary evil.

-- Such reversals would be particularly difficult for Prime Minister Laurent Fabius, who has said publicly that "a return to expansion would rekindle inflation, weaken the franc, and be irresponsible."

On balance, we believe that what room for easing economic policy exists will be saved for the runup to the 1988 presidential election rather than spent on the 1986 National Assembly elections. Initial small steps and a major announcement might be made just before the Assembly elections, however, in hopes of a benefit from the announcement but with implementation saved for late 1986 or 1987. 25X1

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External Risks

The French have adopted economic policy measures that we believe will lead to a current account surplus in 1985, assuming the present trend in the world economy continues. With the improved current account outlook and the continuation of current macroeconomic policy, France should have no difficulty in refinancing its debt. French borrowers have recently been successful at

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[redacted]

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raising financing on favorable terms. [redacted] there is no chance of France falling into arrears, defaulting, or declaring a moratorium. It is extremely unlikely, therefore, that France will need an IMF bailout or a rescheduling of its debt. [redacted] 25X1

For this success to continue, however, growth in the world economy must continue, particularly in the industrial countries, and most observers see the recovery as fairly fragile. A further appreciation of the dollar would also present a problem for the French in the short run by increasing the cost of imports and interest payments, even though it would eventually further increase the competitiveness of French products. [redacted] 25X1

The French also see high dollar interest rates as a continuing threat to their payments balance. The direct impact is to raise the interest payments the French must make on their recently expanded dollar debt. Perhaps more importantly, the French believe that high interest rates threaten the current cyclical recovery and dampen long-term world growth prospects by hindering capital accumulation. Finally, the French hold that high interest rates burden the heavily indebted LDCs, forcing them to reduce imports further or reschedule debt payments. LDCs are particularly important to France because they are the only major country group with which the French are able to run a consistent surplus. [redacted] 25X1

Implications for US-French Relations

Since the Socialists came to power in 1981, they have been highly critical of US economic policy. They hold the United States largely to blame for the failure of the world economy to recover more rapidly from the second oil shock. More recently, they have acknowledged the benefits they have received from the unexpectedly robust US expansion but are displeased with the combination of policies used to bring it about. Specifically, they complain about the mix of large US budget deficits and tight monetary policy, which they believe has created high real interest rates and an overly strong dollar. Former Finance Minister Delors has described the effect of US economic policy on France as equivalent to a "third oil shock." He has charged that Washington has ignored the effect of its economic policies on its allies, undermining their economic strength. [redacted] 25X1

With the US presidential election decided, the French are likely to press the United States to reduce its budget deficit and to lower interest rates, perhaps in muted tones so long as the world economy remains strong. Criticism from Paris will increase if growth slows dramatically or if other events cause a deterioration in the French current account. [redacted] 25X1

The French have long viewed the international monetary system as biased in favor of the United States. When the French economy was growing more quickly than the rest of the world and running large current account deficits, the franc came into almost immediate difficulty, and Paris was forced to alter

[redacted] 25X1

 [redacted] 25X1

its economic policy. By contrast, the US economy was able to grow rapidly in 1983 and 1984 and run huge current account deficits while the dollar appreciated. The world seemed willing to absorb large amounts of dollars but unwilling to hold even small quantities of francs. [redacted] 25X1

The French also argue that sharp swings in exchange and interest rates over the past few years have been due, at least in part, to the excessive importance of the dollar in world financial markets and the failure of the United States to act responsibly as guardian of the de facto world currency. Thus, we expect them to continue to advocate reform that reduces the importance of the dollar while increasing the discipline the system imposes on its dominant member. In 1983 Mitterrand proposed a "new Bretton Woods," and Prime Minister Fabius indicated last fall that France would like to see the European Currency Unit rival the dollar, acknowledging that no single currency could do so. Prior to the Bonn Economic Summit the French continued to insist on the need for international monetary reform, but they still do not have a package of specific proposals to achieve their goals. [redacted] 25X1

[redacted] 25X1

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